No. 92-1384 (27)

In The

Supreme Court of the United States

October Term, 1993

Barclays Bank PLC,

Petitioner,

v.

Franchise Tax Board, an Agency of the State of California,

Respondent.

On Writ of Certiorari to the Court of Appeal of the State of California in and for the Third Appellate District

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BRIEF OF THE MEMBER STATES OF THE EUROPEAN COMMUNITIES (BELGIUM, DENMARK, FRANCE, GERMANY, GREECE, IRELAND, ITALY, LUXEMBOURG, THE NETHERLANDS, PORTUGAL, SPAIN AND THE UNITED KINGDOM) AND THE GOVERNMENTS OF AUSTRALIA, AUSTRIA, CANADA, FINLAND, JAPAN, NORWAY, SWEDEN AND SWITZERLAND AS AMICI CURIAE IN SUPPORT OF PETITIONER

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December 16, 1993

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INTEREST OF AMICI CURIAE

The Member States of the European Communities (Belgium, Denmark, France, Germany, Greece, Ireland, Italy, Luxembourg, The Netherlands, Portugal,

Spain and the United Kingdom) and the Governments of Australia, Austria, Canada, Finland, Japan, Norway, Sweden and Switzerland (collectively, the "Twenty Nations") are major trading partners of the United States. The Twenty Nations comprise more than three-quarters of the membership of the Organization for Economic Co-operation and Development (OECD), the principal economic organization for the developed nations of the world (the United States is also a member), and account for over 95 percent of non-U.S. gross domestic product in the OECD. The Twenty Nations have extensive networks of bilateral double taxation agreements both among themselves and with other nations, including the United States. In their bilateral agreements, and as members of the OECD, the Twenty Nations have uniformly and consistently upheld use of the "arm's length-separate accounting" method of determining income as the proper method to be utilized for purposes of international income taxation.

The question presented in the instant case is whether California's imposition of the so-called worldwide unitary method of taxation on corporations (domestic or foreign) with foreign parent companies is unconstitutional. Resolution of that question is of considerable importance to the Twenty Nations in light of the conflict (explained more fully below) between such method and the internationally accepted arm's length-separate accounting method upon which the Twenty Nations have based their international commercial relations.

The Twenty Nations submit this brief *amici curiae* in support of petitioner.[1]

[1] Petitioner and Respondent have consented to the filing of this brief *amici curiae* in letters filed with the Clerk of this Court.

SUMMARY OF ARGUMENT

The issue of the division of international income for taxation purposes is of fundamental importance to foreign governments generally. The arm's length-separate accounting method is the only internationally agreed upon method for dividing income. It has facilitated growth in international trade and investment, and is adhered to in a wide network of double taxation treaties entered into by the Twenty Nations with the United States and other countries. It is a fact-based standard which comports with economic realities. Far from being easily manipulated and simplistic, as some have argued, it is, in fact, the basis of a sophisticated international tax system.

Imposition by California of its worldwide unitary taxation scheme promotes only disharmony in international relations. It does not seek to divide income in accordance with economic facts, but, rather, by application of standardized formulae. While this may work within the United States where the economy is relatively uniform, it cannot work on an international scale where economic disparities are much larger and fluctuating exchange rates can significantly affect the formulaic allocations.

The Twenty Nations believe that the imposition of worldwide unitary taxation interferes with the longstanding Federal policy of encouraging inward investment because of the uncertainty it creates regarding exposure to double taxation.

The adverse reaction of the Twenty Nations (and others) to worldwide unitary taxation has been con-

sistently expressed since its application by California to foreign-owned multinational groups beginning in the early 1970's. The Twenty Nations believe that this Court should now bring a halt to this type of state interference with the foreign commercial relations of the United States.

ARGUMENT

I. Introduction.

In this brief *amici curiae*, the Twenty Nations wish primarily to inform this Court of the importance to the entire international community of nations of adherence to the arm's length-separate accounting method of determining the proper division of income for international tax purposes. The Twenty Nations align themselves fully with the arguments set forth in the separate brief *amicus curiae* filed by the Government of the United Kingdom with respect to the constitutional issues raised by the instant case.

II. Importance of Division-of-Income Issue to Foreign Governments Generally.

The issue of the proper division for taxation purposes of income earned in international commerce (including income earned from cross-border transactions with third parties or with related corporations established and operating in different countries) is of fundamental importance to the Twenty Nations and, indeed, to foreign governments generally. It affects the competitiveness of national enterprises in international markets, and it impacts on home country revenues both directly (through taxation of income earned there) and indirectly (through the granting of relief from double taxation on income earned elsewhere).

III. Importance of "Arm's Length" Method in International Taxation.

The "arm's length-separate accounting" method contemplates that accounting for profits and losses by members of a multinational group will be made on a separate entity basis. By definition, transactions between completely unrelated parties occur at arm's length and are reported as such. Where transactions occur between related entities in the same multinational group but located in different tax jurisdictions, the income attributable to each jurisdiction will be determined in accordance with the arm's length principle (that is, so that the resulting attribution of income is that which would be expected to result if two unrelated parties dealing wholly independently with each other had engaged in the same or similar transactions under the same or similar conditions). (The term "arm's length method" is frequently used to refer to both the "arm's length principle" and the "separate accounting method.")

The arm's length method was first adopted for use in international taxation by the United States and a number of other nations in the early decades of this century. The method has since been accepted and adopted by all the major developed nations of the world, as well as by the OECD and the United Nations in their model tax treaties and since World War II, in particular, has helped to facilitate the vast growth in international trade and investment.

The arm's length method is the *only* method which has been internationally agreed upon to determine which country should tax the income derived from

the activities of international business.[2] Without that determination, it would not always be possible to reconcile the competing claims of "source" and/or "residence" countries with respect to the taxation of that income.[3] For that reason, the Twenty Nations believe that the importance of the arm's length method in the field of international taxation cannot be overstated.

The arm's length method is inherently factual in its application. The experience of the Twenty Nations over more than sixty years is that the factual inquiry required in applying the arm's length method (which may, of course, result in so-called transfer pricing adjustments being made with respect to particular intragroup transactions in order to place them on an arm's length footing) produces the most equitable results for all concerned—both nations and taxpayers.[4]

Because it relies so heavily on the facts and circumstances of each case, the arm's length method is

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[2] The Twenty Nations understand that there is considerable supporting testimony to this effect in the Trial Record.

[3] There is general agreement among nations that, under the arm's length method, source countries (i.e., the countries where the income-producing activities take place) in principle have the primary claim to tax income arising within their borders.

[4] Transfer pricing methodologies including allocation-type adjustments in certain specific circumstances, are an integral part of the arm's length standard—they do not supplant it, they support it. Double taxation agreements, generally in their Associated Enterprises Article, allow for transfer pricing adjustments which are consistent with the arm's length standard. Furthermore, such provisions are normally supported by the Exchange of Information and Administrative Assistance Article found in such agreements.

said by some to lack precision. However, the experience of the Twenty Nations is that application of the arm's length method allows the most accurate reconstruction in related party transactions of the fair market value of the goods and services produced and sold. Furthermore, the experience gained in the administration of, and in the resolution of disputes arising under, the arm's length method now represents a substantial body of learning. This learning, the Twenty Nations believe, contributes to a sophisticated international taxation system capable of capturing the numerous, subtle nuances of foreign commerce.

The importance of the arm's length method is, therefore, twofold. General agreement on the use and application of the arm's length method has allowed multinational groups of corporations to establish operations in numerous countries with the knowledge that issues of inappropriate double taxation would be addressed on a mutually compatible basis. The arm's length method ensures that the tax revenues of the home countries will not be jeopardized as a result of the extraterritorial effect of taxation policies adopted by other governments, while at the same time allowing the source countries to tax the income actually earned within their countries.

IV. Extensive Worldwide Bilateral Tax Treaty Network Relies on Arm's Length Method as the International Norm.

As noted, each of the Twenty Nations has an extensive network of bilateral income tax agreements. The U.K., for example, has over 90, France 80, Canada 52 and the Netherlands 48. A fundamental feature of such agreements, which is also contained in

the OECD Model Treaty, the U.S. Model Treaty and the U.N. Model Treaty, is a commitment to the arm's length method as the proper standard to be utilized in dividing the income to be derived from intragroup transactions.[5]

Those same agreements also contain what is called the Mutual Agreement Procedure Article (sometimes known as the Competent Authority Article). This Article provides a "safety valve" mechanism that allows the revenue authorities of two competing countries to negotiate disputes that cannot otherwise be resolved.

The competent authority procedure recognizes that differing economic conditions (and different legal and regulatory regimes) will lead to differing economic results. Through direct bilateral negotiations pursuant to their competent authority procedures, the Twenty Nations, and many others, have sought to avoid double taxation and allow for the equitable division of international income for the benefit of both the taxpayers and the fiscs of their respective nations.

V. Effect of Imposition of Worldwide Unitary Taxation.

In contrast to the underlying harmony developed through reliance upon the arm's length method in international commercial relations, imposition by the State of California of its system of worldwide unitary taxation has proved a severe irritant in international relations and has promoted significant disharmony between the Twenty Nations and the United States because, in many instances, it will result either in the double taxation of foreign-owned multinational groups or damage to the fiscs of other nations.

[5] Organization for Economic Co-operation and Development Model Tax Convention on Income and Capital (1992), Art. 9(1); United States Treasury Department's Model Income Tax Treaty of June 16, 1981, Art. 9(1); and United Nations Model Double Taxation Convention between Developed and Developing Countries (1980), Art. 9(1).

The system of worldwide unitary taxation does not attempt to divide income in accordance with the economic facts and circumstances of each individual transaction, as does the arm's length method. Rather, by use of standardized formulae applied to global figures, worldwide unitary taxation apportions income in a way that does not reflect the economic realities of the transactions involved, or the marketplace in which such transactions take place. There is no factual inquiry, and therefore no consideration of the circumstances of individual transactions (whether between related or unrelated parties). There is, rather, a blanket application of standardized formulae to all situations, driven by the assumption that certain uncompensated "flows of value" are more likely to be captured by a formulaic approach than by a facts and circumstances analysis.

California may contend that, in imposing its system of worldwide unitary taxation, it does not tax the income of non-California corporations but only the income attributable to the California part of a unitary business. The Twenty Nations strongly disagree with such a contention. The effect of worldwide unitary taxation is to assign to the California tax base—and therefore to tax—a portion of the group's income earned throughout the world. By definition, therefore, worldwide unitary taxation reaches income earned outside of California. The fact that the formula chosen by California to determine its "fair" portion of that income consists of California-related factors such as

property, payroll and sales does not comport with, and in fact completely ignores, long-accepted international norms for determining income earned in a particular taxing jurisdiction on a separate accounting basis.

Moreover, through use of its three-factor formula—particularly with its proportionately higher wage rates and property values—California may well assign to the Californian part of a unitary business substantially more income than may have been earned there.[6] The Twenty Nations believe that such a result is seriously distortive of economic reality and therefore is inherently inequitable. Indications from this Court that it is willing to intervene only if the apportionment is shown to be "out of all appropriate proportion to the business transacted" are not particularly reassuring. *See Container Corp. of America* v. *Franchise Tax Board*, 463 U.S. 159, 180-181 (1983)

The theory underlying the use of formulae to apportion the income of a unitary business is that each dollar invested in property and wages and each dollar generated from sales produces roughly the same amount of income for the group, and that all of the income of the unitary group accordingly can properly be divided on the basis of the location of its property, payroll and sales. The Twenty Nations understand that the unitary system had its genesis in the taxation of the transcontinental railroads in the later decades

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[6] By way of example, a start-up subsidiary of a foreign parent undertaking operations in California might incur significant early losses and yet be taxed on some portion of the worldwide profits of its group because of the manner in which California's apportionment formula operates.

of the nineteenth century. Even one hundred years ago, there were substantial elements of national uniformity within the United States—most notably a single currency. The growth in application of the domestic unitary method of taxation in this century has been mirrored by increasing national uniformity. Within the United States, there is a national minimum wage, national workplace standards and uniform national accounting standards. Congress has established the Federal Reserve System, expressly charged with pursuing national economic and financial objectives, including price stability, stability in the purchasing power of the dollar, and a safe and flexible banking system. The development of sophisticated financial markets ensures that similar businesses throughout the nation have access to capital on equal terms. All of this means that within the United States, the application of a standard unitary apportionment formula is not likely to produce results that are dramatically inconsistent with economic reality.[7]

Because of vastly differing economic and legal conditions among the nations of the world, however, the assumptions of the unitary system are, quite simply, inapplicable on an international scale. In particular, the use of more than one currency in the activities of a multinational group makes the assumption underlying the unitary principle completely inappro-

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[7] The Twenty Nations do not in any way intend to comment on how the States divide income within the United States. If such division is by way of unitary formula, however, the formula should not be applied to income arising beyond the "water's edge" of the United States (as has now generally been acknowledged by the State of California in its most recent legislation passed in October 1993).

priate internationally. Exchange rate fluctuations will, for example, affect the allocation of profit by affecting both the numerator and denominator of the apportionment formulae. In other words, changes in exchange rates can lead to a change in the allocation of a multinational group's profits that is completely unrelated to the business activity actually undertaken.[8]

Furthermore, the unitary formula takes no account of variations in wage rates between countries. A corporation may choose to locate a subsidiary in a low wage country in the expectation that operations in that country will, as a result, be relatively more profitable than operations elsewhere. Worldwide unitary taxation turns this economic decision on its head by allocating—simply by application of a formula—some of those profits to high wage jurisdictions.

Moreover, multinationals take account of a wide range of factors in deciding where to locate their subsidiaries. These include the extent to which firms must comply with burdensome local regulations, the availability and cost of finance as determined by the nation's capital market, the quality of the transpor-

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[8] For example, a change in exchange rates between Country A (in which State A uses worldwide unitary taxation) and Country B, from 1:1 to 1:2, where State A had claimed 50% (10/20) of the income of a group before devaluation, would lead to State A claiming 67% (10/15) of such income after devaluation.

By contrast, a change in exchange rates will affect arm's length calculations only to the extent that transactions take place between the two countries requiring currency to be exchanged. The impact of exchange rate changes on the division of income for tax purposes therefore accords with their true economic impact.

tation infrastructure, and the availability and cost of natural resources and other factors, such as water and utilities, critical to the production process. These factors vary substantially between countries and they will influence the profitability of firms, which is why close attention is paid to them before a decision to locate in a particular country is taken. Yet the assumption behind worldwide unitary taxation is that all workers, all property and all sales are equally profitable the world over. If this were the case, corporations would be indifferent about where they located their operations.

The Twenty Nations are aware that a number of these issues were examined by this Court in *Container Corp., supra.* The majority there found fault with the arm's length method as "subject to manipulation and imprecision, and often ignores or captures inadequately the many subtle and largely unquantifiable transfers of value that take place . . . ." 463 U.S. at 164-165. The Twenty Nations wish to apprise this Court that their experience in constructing and administering an international taxation system that has been based upon the arm's length method for over sixty years has led them to conclude that it is neither easily manipulated nor simplistic. In the context of international income taxation, the Twenty Nations also believe that their extensive experience with, and continuing adherence to, the arm's length method is more relevant to the issues before this Court than the experience of the several states.

In short, the Twenty Nations firmly believe that the enormous variations in economic and legal conditions throughout the world realistically lead to the conclusion that the arm's length method is the only

system capable of reconciling such differences. Those variations render the assumptions on which unitary taxation is premised fundamentally inapplicable on a worldwide basis.

VI. Imposition of Worldwide Unitary Taxation by States Runs Directly Contrary to Efforts of U.S. Federal Government to Encourage Foreign Investment by Providing a Tax Environment Consistent with International Standards.

In the United States, the regulation of commerce with foreign nations has always been the exclusive province of the Federal Government. Foreign commerce includes flows of capital across borders—international investment as well as international trade. The Federal Government has consistently undertaken to attract inbound international investment as that adds to the stock of capital available in the United States. In order to attract such capital, the United States must provide foreign investors with certain assurances, particularly as to how the return on their capital will be taxed and whether it will be taxed in accordance with international standards.

The extensive network of bilateral double tax treaties entered into by the United States, based as it is on a common commitment to use of the arm's length method, is designed to provide assurances for international investors that they will not suffer inappropriate double taxation on the profits from their investments.[9] Similar assurances can be found in the Treaties of Friendship, Commerce and Navigation

[9] *See* prepared statement of Hon. Leslie B. Samuels, Assistant Secretary of the Treasury (Tax Policy) before Senate Foreign Relations Committee, Hearings on Tax Treaties (with Russian

which several of the Twenty Nations have entered into with the United States (all of which were entered into before California began imposing worldwide unitary taxation on foreign-owned groups).

By contrast, the unitary method can actively discourage foreign investment. As U.S. Secretary of the Treasury Blumenthal noted in a letter to Martin Huff, Executive Officer of the California Franchise Tax Board, on February 15, 1977, "The unitary system imposes a substantial compliance burden on multinational corporations. . . . We are aware of cases where this burden has discouraged foreign investment."[10] The "chilling effect" of unitary taxation on investment policy was spelled out even more clearly by U.S. Secretary of the Treasury Baker, who wrote to Chairman Rostenkowski of the House Ways and Means Committee on March 5, 1986:

> The United States is strongly committed to encouraging the free movement of international direct investment capital across national boundaries. State use of the worldwide unitary method is unacceptable because it can adversely affect this clearly articulated federal policy. The United States, as the country hosting the largest amount of foreign direct investment, has gained enormously from the

Federation, *et al.*), October 27, 1993, 103rd Congress, 1st Sess. at 2-4.

[10] Hearings on Tax Treaties with United Kingdom, *et al.*, before Senate Foreign Relations Committee, July 19 and 20, 1977, 96th Congress, 1st Sess. at 412. (Exhibit 37c.) (All references to exhibits are to those in the Joint Stipulation of Facts contained in pages A-36 to A-73 of the Appendices to Petition for a Writ of Certiorari filed in the instant case.)

> inflow of foreign investment. If the use by some of our states of the worldwide unitary method inhibits the flow of capital, the economic well-being of the country as a whole would suffer.

Exhibit 46n.

There is an inevitable tension, therefore, between the Federal policy of encouraging foreign investment in the United States and the use by individual States of a taxing scheme which is not consistent with the taxing schemes adopted and utilized by the other nations of the world. That inconsistency introduces considerable uncertainty into the inward investment equation.

VII. Adverse Reaction of Foreign Governments to Worldwide Unitary Taxation is Well-Documented.

Since the late 1970's the Twenty Nations have, sometimes individually and sometimes in concert, expressed their dissatisfaction with worldwide unitary taxation to the various United States Administrations. In addition to a considerable number of diplomatic notes and other formal communications,[11] the U.K. has passed retaliatory legislation,[12] the French and Canadian Governments expressed their concerns when ratifying their double tax treaties with the United States,[13] the Netherlands held up treaty negotiations with the United States from 1984 to 1988, and most

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[11] *See* list in Appendix A hereto and Exhibit 32b., *et seq.*

[12] Now Sections 812-815, Income and Corporation Taxes Act, 1988, (Exhibit 35).

[13] Exchanges of Notes, November 24, 1978 and September 26, 1980 (Exhibits 43 and 42 respectively).

recently, the Finance Committee of the German Bundestag requested the German federal government to consider retaliatory action if the unitary tax issue was not quickly resolved.[14]

The Twenty Nations, consonant with both international custom and the United States Constitution, may only deal formally with the Federal Government. Art. I, § 10, cl. 1; Art. II, § 2, cl. 2; and, Art. II, § 3. Furthermore, the Twenty Nations understand that part of the reason for the vesting of the exclusive power to regulate foreign commerce in the Federal Government was to avoid the "economic balkanization"[15] that would result if each state were to conduct its own foreign economic relations.

If the States are allowed to impose taxes such as worldwide unitary taxation, which result in the international division of income in a manner that is contrary to the fundamental rules of international tax law, the Twenty Nations believe that their commercial relations with the United States are likely to become severely strained. Surely, in the absence of express authorization from Congress, the Framers of the United States Constitution could not have contemplated the taxation of foreign commerce by a state in a way that could lead to such adverse consequences to the Nation as a whole. This Court should reject the position of California and thereby bring a halt to this type of state interference with the conduct of this country's foreign commercial relations.

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[14] Resolution of June 30, 1993.

[15] *Wardair Canada, Inc.* v. *Florida Dep't of Revenue* 477 U.S. 1, 7 (1986) (quoting *Hughes* v. *Oklahoma*, 441 U.S. 322, 325-26 (1979)).

CONCLUSION

For all of the foregoing reasons, the decisions of the courts below should be reversed and California's mandatory worldwide unitary taxing scheme should be held unconstitutional.

Respectfully submitted,

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APPENDIX

APPENDIX

Diplomatic Notes and Other Formal Communications

Demarche from Italy, President European Communities, on behalf of the Member States of the European Communities, March 19, 1980;

Demarche No. 51 from the British Embassy, March 25, 1980;

Demarche No. 211 from the United Kingdom, President European Communities, on behalf of the Member States of the European Communities, October 30, 1981;

Demarche No. 692 from the Canadian Embassy, December 22, 1981;

Demarche No. 83 from the British Embassy, May 18, 1982;

Demarche No. 283 from the Canadian Embassy, June 14, 1982;

Demarche from Belgium, President European Communities, on behalf of the Member States of the European Communities, June 29, 1982;

Demarche from Greece, President European Communities, on behalf of the Member States of the European Communities, August 1, 1983;

Aide-Memoire from Government of Japan, August 11, 1983;

Demarche from Greece, President European Communities, on behalf of the Member States of the European Communities, September 23, 1983;

Demarche No. 481 from the Canadian Embassy, September 28, 1983;

Demarche No. 383/83 from Embassy of Australia, November 7, 1983;

Demarche No. 461.20-LJ/hu from Embassy of Switzerland, November 15, 1983;

Demarche from the Federal Republic of Germany, November 28, 1983;

Demarche No. EA-14533 from Embassy of The Netherlands, December 21, 1983;

Demarche from Embassy of Belgium, January 25, 1984;

Demarche from Belgium, President European Communities, supported by the Member States of the European Communities, the European Commission, and the Embassies of Australia, Japan, Canada, and Switzerland, January 30, 1984;

Demarche No. 634 from the Canadian Embassy, February 27, 1984;

Aide-Memoire from Government of Japan, June 6, 1984;

Demarche from Ireland, President European Communities, on behalf of the Member States of the European Communities, December 20, 1984;

Demarche from the Commission of the European Communities and the Embassy of Luxembourg, August 8, 1985;

Demarche from Member States of the European Communities and the Commission of the European Communities, August 30, 1985;

Letter from Ambassador of Spain on behalf of Member States of the European Communities to U.S. Secretary of State, James A. Baker, III, June 30, 1989;

Demarche from the United Kingdom, President European Communities, on behalf of the Member States of the European Communities, July 22, 1992;

Demarche from the Embassy of Belgium, President European Communities, on behalf of the Member States of the European Community, and from the Delegation of the Commission of the European Communities, September 24, 1993;

Demarche from the British Embassy on behalf of the Member States of the European Community and the Governments of Australia, Austria, Canada, Finland, Japan, Norway, Sweden and Switzerland, October 14, 1993.